

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549

**FORM 10-KSB**

Annual Report Under Section 13 or 15 (d) of the Securities Exchange Act of 1934

For the fiscal year ended **December 31, 2003**

Commission file number: **33-3362-D**

**KLEENAIR SYSTEMS, INC**  
(Name of small business issuer in its charter)

State of Nevada  
(State or other jurisdiction of  
incorporation or organization)

87-0431043  
(I.R.S. Employer  
Identification #)

1711 Langley Avenue, Irvine, CA  
(Address of principal executive offices)

92714  
(Zip code)

Issuer's telephone number: (949) 955-3492

Securities registered under Section 12 (g) of the Exchange Act: Common stock, no par value

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Exchange Act during the past 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Check if disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. ☒

State issuer's revenues for its most recent fiscal year: \$754,885

The aggregate market value of the voting stock held by non-affiliates of the registrant on March 31, 2004, was \$9,269,071 based on the closing stock price on that date.

The number of shares outstanding of the registrant's common stock on March 31, 2004, was 42,158,827 shares.

## PART I

### Item 1. Description of Business

The Company was incorporated under the laws of the State of Nevada on February 4, 1986, under the name of Covington Capital Corporation. In 1986, the Company filed an S-18 and registered certain stock. From 1989 through 1993, the Company underwent a series of name changes in order to explore various business opportunities. However, none of the business opportunities was successfully completed.

In April, 1995, under the name Investment and Consulting International, Inc., the Company acquired a patent for a proprietary device designed to neutralize nitrogen oxide automobile emissions from a separate Company which was then known as KleenAir Systems, Inc. Simultaneously with the acquisition of the patent, the Company acquired the right to use the corporate name "KleenAir Systems, Inc.," and changed to its current name.

Since acquiring the patent in 1995, the Company has been a developmental stage company and has worked towards the completion of the development and testing of the NOxMaster™ technology. The Company owns U.S. Patent #5,224,346 Engine NOx Reduction System issued in 1993, U.S. Patent #5,609,026 Engine NOx Reduction System issued in 1997. In 1999 the Company was issued a third patent on Ammonia Injection in NOx Control, U.S. Patent #5,992,141. The Company has applied for and maintained patent protection under the Patent Cooperation Treaty (PCT) to protect its intellectual property in a variety of countries that are significant producers of automotive products.

The Company has applied for additional patents related to its NOxMaster™ technology. In September 2002, a patent U.S. # 6,446,940 B1 was issued for the Sonic Flow Carburetor, a new emission control device that atomizes fuel on gasoline powered engines. This enhances operating efficiency and reduces emissions. Another patent, U.S. # 6,499,463 B1 was issued in December 2002 for a Diesel Fuel Atomizer. This device facilitates improved diesel combustion, lower fuel use, and lower emissions of particulates and CO2.

Patent awards have now been confirmed for several European countries including the U.K., Germany, France, Italy, Spain and Sweden, and are anticipated soon for Japan, Brazil, and China.

In May 2002, the Company leased a 10,000 square foot R & D and office facility at 1711 Langley, Irvine, CA 92614. The Company has also acquired a new chassis dynamometer in addition to its engine dynamometer to cope with increasing levels of R & D engine and device testing programs as it prepares for commercializing its technology.

In 2003, the Company successfully completed the final phase of its London Taxi Program funded by a U.K. government grant. This in-service test, involving several London taxicabs, started in January 2002. The Company has been notified that its NOxMaster™ system has been approved for the Cleanup Register making it eligible for U.K. government retrofit subsidies. There are approximately 40,000 such taxicabs in service that represent the potential market opportunity should the system be endorsed as the preferred retrofit product.

It is believed that the Public Carriage Office (PCO) will mandate the retrofit upgrade of some 17,500 out of the current fleet of approximately 22,000 taxicabs in London. It is expected that these taxicabs will be required to upgrade to a Euro 3 level, the emissions level currently required of new cabs. The same system can also be adapted as a retrofit and OEM product for the general diesel-powered passenger automotive market, which represents approximately 45% of the registered and new vehicle market in Europe.

Installation of test systems consisting of a combination of KleenAir System's SCR and Dinex's particulate reduction (DPF) products has resulted in the creation of a new device category by the Energy Savings Trust (EST) called SCRF, the combination of Selective Catalytic Reduction and a Filter. This category receives the Trust's highest level of subsidy. KleenAir's NOxMaster™ System has also been approved for light, medium and heavy duty applications including taxicabs, delivery vans, shuttle buses, single and double-decker large buses, refuse collection vehicles and trucks.

These approvals open a broad spectrum of potential applications covering a retrofit market opportunity of several hundred thousand vehicles in the U.K. alone. They also set precedents and demonstration opportunities leading to similar applications in other European countries. For example, in Denmark several buses in Copenhagen had KleenAir Systems successfully installed and tested and more systems will be installed on buses during 2004.

During 2003 tests were conducted of a combination of KleenAir's NOxMaster™ System and Adastr's Optimax-DPF fuel borne catalyst system for particulate reduction. Adastr, an Octel (NYSE) company in the U.K., has already had its DPF system approved by the EST for a number of vehicle applications and, on conclusion of the current tests, it is anticipated that the KleenAir/Austr system will be the second entry into the SCRF category.

Systems ordered by several other London Boroughs, and installed on both refuse collection trucks and buses during 2002, have performed well. As a result, those systems have been added to the EST Cleanup Register. As a result, KleenAir and Dinex are now targeting the 100 Air Quality Management Areas (AQMA) established by Local Authorities throughout Britain. These AQMAs have the authority to establish emission rules for their districts to improve their local air quality. It is believed that such AQMAs will take actions leading to the need for vehicles in a variety of categories to retrofit emission control devices such as the KleenAir/Dinex products.

U.S. testing continues of the NOxMaster™ Diesel Catalytic Converter together with its NOxMaster™ Ammonia Injection System to present an integrated system for the elimination of emissions from diesel powered mobile sources. In order to sell the Company's products in California an Executive Order (EO) is required from the State of California. The Company must demonstrate under prescribed testing protocols that its products do not increase the level of exhaust emissions. The Company has received an EO certification from the California Air Resources Board (CARB) for off-road and stationary engine applications. This allows for commencement of sales of the Company's products related to these applications in California. EO certification for on-road applications is expected shortly.

The Company is preparing to meet CARB and EPA Retrofit Verification requirements for heavy-duty vehicles on both its NOxMaster™ NOx reduction system and its Oxidizing Particulate Trap (OPT). It has applied for Retrofit Verification of the combination package of its OPT with the NOxMaster™ for both high particulate reduction as well as high NOx reduction. The EPA has now published its Selective Catalytic Reduction Protocol (SCR). The absence of this protocol has previously prevented the Company from commencing certification procedures.

In 2003, the Company acquired Carbon Cloth Technologies, Inc. (CCT) of Malibu, California. CCT is a manufacturer of automotive thermal management systems. Carbon Cloth has years of experience developing thermal solutions for such motor sports industry leaders as Ferrari, Mercedes-Benz, and Penske. This experience has enabled development of the CarbonGuard™, a significant addition to the battle on pollution.

The CarbonGuard™ is currently installed on a number of New York City Transit Authority buses as enhancements for the operating efficiency of an installed base of particulate traps. A further several hundred buses were upgraded with the CarbonGuard™ during 2003. Multiple prototype variations have been purchased by a number of automotive OEM manufacturers with a view to their incorporating the CarbonGuard™ for a variety of thermal management applications.

Carbon Cloth Technologies has applied for patents in automotive thermal management systems. At present, this system is used to enhance the effectiveness of particulate filters that need to maintain 300 degrees centigrade for 30% of a vehicle's operating time. At lower temperatures, the filters clog and create back pressure. Wherever particulate filters are currently installed, at present estimated to be at least 30,000 units, the CarbonGuard™ can improve performance and save maintenance expense. Filter technology has come to prominence recently as the Environmental Protection Agency (EPA) and the California Air Resource Board (CARB) have determined that particulate emissions from vehicles are a serious public health problem.

The Company signed a marketing agreement in 2002 with ServoTech. Under this agreement, the Company earns a commission on any ServoTech's SOBRIS™ system sales it may generate. This system is a competing method of NOx emission reduction that utilizes urea and aqueous ammonia in a system that introduces these reductants into an exhaust system. ServoTech is a licensee of Ford Motor Company on SCR injection technology. The SOBRIS™ product is under test and evaluation by a number of automotive manufacturers in the U.S. and Europe.

Once production and sales of the NOxMaster™ and OPTs get to a consistent phase, the Company anticipates employing initially 15 to 20 employees, primarily in management, technical and administrative capacities. The Company is actively seeking sources of funding for its operating capital requirements, both to complete its test and evaluation programs and to support initial sales and production.

The Company has not been involved in any bankruptcy, receivership or similar proceeding.

In May 1997, the Company undertook a one (1) for fifteen (15) reverse split of its common outstanding shares leaving the par value at \$.001 per share. The number of issued and outstanding shares was reduced to 362,157 while its authorized shares remained unchanged at 50,000,000. The Series 1 Preferred Shares were similarly effected by the same 1 for 15 reverse split and were reduced to 500,000 shares. In January 2000, the last of the outstanding preferred shares were converted into common shares at a ratio of 1 common share for each share of Series 1 Preferred. In February 2000, the Board of Directors approved a 2 for 1 stock split effective March 20, 2000.

The NOxMaster™ is an electro-mechanical device that substantially reduces the oxides of nitrogen (NOx) from the exhaust gases of cars and trucks (mobile sources) fueled by gasoline, diesel or natural gas.

The purpose of the NOxMaster™ is to reduce NOx emissions to a level substantially lower than the minimum requirements of even the most restrictive state - California. The NOxMaster™ is a one-of-a-kind device, that can effectively accomplish this task and consists of: 1) an ammonia injector located on the engine exhaust system upstream of the catalytic converter; 2) a tank of minimally pressurized ammonia with solenoid operated valves; 3) tubing, wiring, and an electronic controller that senses engine parameters.

A timing pulse from the engine is used to determine certain parameters that indicate NOx production and to trigger a solenoid causing the injection of gaseous ammonia into the exhaust system upstream of the catalytic converter. The chemical reaction that occurs causes the NOx to be reduced to harmless constituents primarily at the initial mixing and secondarily at the catalytic converter. The ammonia injection is programmed to occur only when the engine is operating at specific load and performance conditions.

In addition to a cost effective reduction of NOx emissions from the exhaust, the NOxMaster™ has the potential of aiding the enhancement of engine performance. Controlled reduction of NOx emissions could allow for the re-tuning of the engine for increased efficiency. This would result in increased fuel mileage while continuing to meet the government-set NOx emission standard.

The Company has complemented its NOxMaster™ Ammonia Injection System with a NOxMaster™ Diesel Catalytic Converter for the purpose of applying its NOx reduction technology to diesel fueled engines while also reducing carbon monoxide, hydrocarbon, and particulate emissions from such engines. It has done so through the development of specially formulated ceramic wash-coats that allow for ammonia in the atmosphere and that provide a significant particulate reduction for the retrofit market. It is planning the acquisition of plasma technology capable of much greater reductions of particulate emissions, particularly ultra-fine particulates, the health hazards of which are getting increasing attention by the EPA. Such an integration of an ammonia-based NOx reduction system and a plasma particulate reduction system will be well suited to both the OEM and retrofit markets.

In order to conserve operating capital, the Company currently has one paid full-time employee and 4 paid part-time employees. It has retained the services of its management, officers and certain consultants through the issuance of restricted Section 144 common stock.

In June 1996, five employment and consulting contracts with 30 months remaining and valued at over \$1,000,000 were voluntarily terminated by the parties concerned, with no future recourse or liability for the Company, including the employment contracts of Lionel Simons, President and Lester Berriman, Chairman. Mr. Simons and Mr. Berriman agreed to continue managing and directing the Company without cash compensation until such time as adequate operating capital had been secured for the Company. Peter Cahill resigned from the Board at this time and William H. Ward, Jr. was appointed to the Board to serve along with Mr. Simons and Mr. Berriman.

In December 1996, the Company, having no resources available for the international commercial exploitation of its technology rights, and having no business plan for such exploitation of rights outside of the U.S., entered into a licensee agreement with an officer of the Company. This license was for the exploitation of European rights to the technology for application to gasoline engines and for exploitation of worldwide rights for diesel engines. The agreement called for the Company to receive an 8% royalty plus 30% ownership of a Company to be established overseas. This Company was subsequently formed and called KleenAir Systems International, Inc. It established a wholly owned subsidiary in the U.K. called KleenAir Systems Ltd. During 1998, the U.S. exploitation rights for that

portion of the technology relating to diesel engines was transferred back to the Company in exchange for an issuance of restricted shares.

The Company began distribution of its CarbonGuard™ thermal management system during 2002 and has shipped its NOxMaster™ products in 2003.

Management believes that the NOxMaster™ system is unique, well protected by patents, and that it will prove to be effective and marketable after completion of testing. Competition is anticipated from so-called urea systems, such as the SOBRIS™ system, that are more complex and significantly more costly, but whose end result is the creation of ammonia to catalyze a chemical reaction with NOx in the exhaust system.

Development expenses were \$196,534 during 2003. During 2002 they were \$337,773.

The Company does not intend to deliver an annual report to security holders. The public may read and copy any materials filed with the SEC such as this 10-KSB and 10-QSB reports. The Company is an electronic filer under the SEC's EDGAR filing program. The SEC maintains an Internet site at [www.sec.gov](http://www.sec.gov) that contains such reports and other information filed electronically which is available to all security holders.

## **Item 2. Description of Property**

In May 2002, the Company leased a 10,000 square foot R & D and office facility at 1711 Langley, Irvine, CA 92614. The Company has also acquired a new chassis dynamometer in addition to its engine dynamometer, computers and other test equipment to cope with increasing levels of R & D engine and device testing programs as it prepares for commercializing its technology.

The Company does not engage in mining operations, oil and gas producing activities or real estate activities.

## **Item 3. Legal Proceedings.**

The Company is not currently the subject of any litigation.

## **Item 4. Submission of Matters to a vote of Security Holders.**

There were no submissions to a vote of security holders during 2002.

# **PART II**

## **Item 5. Market For Common Equity and Related Stockholder Matters.**

Market Information: The principal trading market for the common equity securities of the Company is the National Association of Securities Dealers OTC Bulletin Board quotation system. The following are the highs and lows for each quarter for fiscal year ended December 31, 2003 and 2002, respectively. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commissions, and may not represent actual transactions.

	2003		2002	
	<u>High</u>	<u>Low</u>	<u>High</u>	<u>Low</u>
1st Quarter	\$0.51	\$0.22	\$2.45	\$1.10
2nd Quarter	0.35	0.20	1.80	0.75
3rd Quarter	0.35	0.16	1.01	0.47
4th Quarter	0.34	0.20	0.75	0.30

Shareholders: At December 31, 2003, there were 541 shareholders of record with an additional approximately 64 shareholders registered with firms reporting to the Depository Trust Company.

Dividends: No dividends have been paid in the last two fiscal years.

#### **Item 6. Management's Discussion and Plan of Operation.**

During 2003, the Company started delivering its patented NOxMaster™ NOx Reduction System. Sales for the year topped \$750,000 as compared to approximately \$50,000 in 2002.

This consisted mainly of shipments of components to Dinex A/S in Denmark who then manufactured completed systems which have been installed on buses, taxis, shuttles and refuse collection vehicles in test quantities. It is expected that field demonstrations of the system will lead to significant orders during the course of the current year and into the future.

The Company is positioning itself to be a leading provider of Selective Catalytic Reduction (SCR) systems in the European market where it has achieved certification status with the Energy Savings Trust (EST) in the U.K. and meets all the retrofit standards for the other EU countries.

The Company owns a number of significant patents which it believes gives it special advantage in the SCR market worldwide and has applied for patents on systems that combine particulate and NOx reduction systems which will further extend its market value.

The Company's original U.S. Patent # 5,224,346 was acquired in April of 1995. U.S. Patent # 5,609,026 "Engine NOx Reduction" was issued in 1997 after successfully overturning a challenge in Patent Court. International patent rights have been granted for these patents and have been issued for Europe (patent # 5 638 139 covering Germany, France and the U.K.) and international coverage extends to certain Asian countries and Canada as well as Brazil and certain other countries.

On November 30, 1999 the Company was issued a third patent on "Ammonia Injection in NOx Control", U.S. Patent # 5,992,141. This patent deals with the NOxMaster™ ammonia injection control system and chemical reaction enhancement techniques to ensure optimum effectiveness of the system to achieve maximum NOx reduction. In the opinion of management, this patent significantly strengthens the position of the Company in the exploitation of its technology and increases the value of its future commercial exploitation and licensing potential. Management believes that its patent coverage in all the major automobile and truck producing countries provides it with the patent protection necessary to successfully exploit the technology world-wide. No value has been capitalized on the books for the second and third patents.

Two additional patents were applied for during 2001 that improve the NOxMaster™ device in specific relation to its reduction of particulate emissions. The Company believes that a system that reduces particulate emissions as well as oxides of nitrogen meets the two major mobile source pollutants of greatest concern to the mandating authorities, such as the EPA and CARB.

The Company continued testing on its Sonic Flow Carburetor with a patent granted in September 2002 (U.S. 6,446,940). This device significantly improves fuel-burning efficiency and reduces emissions on gasoline engines by effectively atomizing the fuel into very fine particles for an even and homogenous distribution throughout the engine cylinders.

The Company is positioning the Sonic Flow Carburetor as a low cost alternative to a fuel injection system for the two wheel market in China and India. It offers more power, greater fuel economy and lower emissions at significantly lower cost. In China some 12 million two wheel vehicles are manufactured annually. The Company has a test and evaluation agreement with a major manufacturer of some 2 million vehicles with the a view to replacing their carburetor systems with the Sonic Flow Carburetor

A similar Sonic Flow concept is employed in the Company's new duel fuel injector on which a patent was issued in December 2002. This device is designed to improve operating efficiency and reduce emissions on diesel engines by using regular diesel fuel to commence fuel combustion and then switch to atomized fuel. These new products are the result of following through on the Company's mission to develop technologies that significantly reduce polluting emissions and improve operating efficiencies.

The original product, the NOxMaster™ device is currently being prepared for commercialization in the U.K. and Denmark. Also, Retrofit Verification by the EPA and the California Air Resource Board (CARB) has been applied for in the U.S..

Nitrogen Oxides (NOx) are the most difficult auto exhaust pollutants to control. They are not from the engines fuel but are produced by the oxidation of nitrogen in the combustion of air. Their formation requires high temperature (2500 degrees F and above). The higher the temperature, the more NOx is produced. Thus NOx is produced in proportion to engine power output and efficiency. Meeting even the current minimum standards requires sacrifice of performance and economy.

The NOxMaster™ utilizes both the non-catalytic reaction that occurs at high temperature, and the catalytic reaction at lower temperature. Tests have confirmed this approach. Further test data has shown the desired reaction does occur in the presence of excess air (oxygen) and might even be enhanced by the oxygen. Thus the NOxMaster™ device gives the manufacturer a method of control that is essentially independent of engine operating parameters and provides new options for economy and performance.

The product can also be distributed in states other than California where an Executive Order (EO) is required before distribution can commence. The Company has received an EO from the CARB in enabling it to sell its product in the State of California. The EO states that the product does not increase NOx emissions and will allow the Company to sell the product(s) in the state of California.

The recently introduced requirement to secure a Retrofit Verification approval from the CARB or EPA for SCR technology is needed in order to qualify for SIP and Emission Trading Credits. These enable the user to sell credits to cover the cost of equipment and operations.

The Company applied for EPA and CARB Retrofit Verification in the fourth quarter of 2003 in line with new protocols for Selective Catalytic Reduction (SCR) now finalized by those agencies. These verifications are necessary to permit sale of the Company's NOxMaster™ system nationwide and to qualify its customers for emission credits. The emphasis for emission trading credits is on NOx reduction products, thereby satisfying the mobile source emission reduction criteria for "emission credits". The Guidelines for the Generation and Use of Mobile Source Emission Reduction Credits, published by the California Environmental Protection Agency, Air Resources Boards and Mobile Source Emission Reduction Credits were approved by the ARB on February 19, 1993.

The document states that NOx is the only pollutant considered in the guidelines as a reasonable candidate for credit generation. These emission credits are currently traded on a commodity-like exchange and are valued in the range over \$20,000 per ton. The Company believes the value of these emission credits will be a very substantial tool in the marketing of the NOxMaster™ products to fleet vehicle owners, especially the diesel transportation industry.

The Company has established an limited liability partnership in partnership with Emission Credit Brokers of Houston, TX for the purpose of facilitating the use of credits to self-finance the application of the Company's emission reduction products to commercial vehicle fleets in those areas of the country where such trading credits are available.

The Company has signed a distribution agreement with DINEX A/S of Denmark and its U.K. subsidiary, Dinex U.K. Ltd. Under this agreement DINEX has a non-exclusive right to sell the Company's products in its market area (Scandinavia, U.K., Germany, France, Italy and Spain).

Once production and sales begin, the Company anticipates employing initially 15 to 20 employees, primarily in management, technical and administrative capacities. The Company is actively seeking sources of funding for its operating capital requirements both to complete its test and evaluation programs and to support initial production and sales.

On December 29, 1999 the Company signed a Letter of Intent with Extengine Transport Systems, LLC regarding the awarding of licenses for commercial exploitation of the Company's technology in China, India, California and the U.S. Urban and School Bus markets. This was subsequently followed by completion of Licensing Agreements, the exclusive terms of which, if fulfilled, would represent significant income to the Company over the succeeding 10 years. As part of the Agreement, Extengine Transport Systems LLC has invested funds in the Company to cover the costs of research and development to fulfill contracts requiring the demonstration of NOx reduction capability with regard to a number of engines supplied by major Chinese automotive companies. Discussions have also been held with various California Transportation Authorities with regard to the testing of the Company's products on its buses as part of the Extengine drive to exploit the Company's technologies in the Urban Bus market.

This license has now, by mutual agreement, been set aside. Extengine no longer has exclusive rights for India and China, but instead has been given exclusive rights for Hong Kong, Korea, and Japan. It also retains an exclusive right in the U.S. Urban Bus market and non-exclusive rights to sales of products utilizing KleenAir Systems technology in the U.S. and certain other limited territories overseas.

The Company has moved into a 10,000 square foot Research and Development facility in Irvine, California where it has expanded its R & D dynamometer testing capabilities and broadened the range of engine types and sizes for which it can customize its products.

Several NOxMaster™ units have been installed and are in service on a number of London Taxicabs where they are continuing field tests. Systems have also been installed on a London Borough 16 passenger Mercedes Sprinter bus and on a number of waste collection trucks in the several other London Boroughs.

A subsequent event in March 2004, was the acquisition by the Jubilee Investment Trust of London, U.K. of \$2.1 million worth of the Company's common stock. This was accomplished by the issuance of 10,026,666 restricted shares of the Company in exchange for 910,569 shares of Jubilee. Jubilee is a British entity listed on the London Stock Exchange.

#### **Disclosure Regarding Forward-Looking Statements**

Where this Form 10-KSB includes "forward-looking" statements within the meaning of Section 27A and Section 21E of the Securities Act, the Company desires to take advantage of the "safe harbor" provisions thereof. Therefore, the Company is including this statement for the express purpose of availing itself of the protections of such safe harbor provisions with respect to all of such forward-looking statements. The forward-looking statements in this Form 10-KSB reflect the Company's current views with respect to future events and financial performance. These forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ from those anticipated. These risks include, but are not limited to, economic conditions, changes in environmental regulations, the market for venture capital, etc. In this Form 10-KSB, the words "anticipates," "believes," "expects," "intends," "future" and similar expressions identify forward-looking statements. The Company undertakes no obligation to publicly revise these forward-looking statements to reflect events or circumstances that may arise after the date hereof. All subsequent written and oral forward-looking statements attributable to the Company or persons acting on its behalf are expressly qualified in their entirety by this section.

#### **Item 7. Financial Statements**

See the Index to Financial Statements on page F-1 following the signature page and of this Form 10-KSB.

#### **Item 8. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure**

None



## Item 8A. Controls and Procedures

### (a) Evaluation of disclosure controls and procedures.

Under the supervision and with the participation of our President and Chief Financial Officer, we conducted an evaluation of the effectiveness of the design and operations of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as of December 31, 2003. Based on this evaluation, our President and Chief Financial Officer concluded that our disclosure controls and procedures were effective such that the material information required to be included in our Securities and Exchange Commission ("SEC") reports is recorded, processed, summarized and reported within the time periods specified in applicable SEC rules and forms relating to our reporting obligations, and was made known to them by others within the Company, particularly during the period when this report was being prepared.

### (b) Changes in internal controls over financial reporting.

There was no change in our internal control over financial reporting during the period covered by this report that has materially affected, or is reasonably likely to materially affect our internal control over financial reporting.

## PART III

### Item 9. Directors, Executive Officers, Promoters and Control Persons: Compliance With Section 16(a) of the Exchange Act

<u>Name</u>	<u>Age</u>	<u>Position/Office</u>	<u>Term</u>	<u>Served Since</u>
Lester Berriman	79	Director/ VP-Research	2 years	April 1995
Lionel Simons	69	Director/President/ Secretary/Treasurer	2 years	Dec. 1995
Hamid Servati	51	Director/Consultant	2 years	Nov. 2002

Lester Berriman, P.E., Chairman and VP-Research. A Professional Engineer with a degree in Chemical Engineering, Mr. Berriman leads the Company in its research and development. Mr. Berriman served 20 years as manager of Chemical and Mechanical Engineering for the Southern California laboratories of the Stanford research Institute and 17 years with Dresser Corporate Advanced technology which included 2 years as their Director of the Advanced Technology Center. Mr. Berriman has 21 United States patents and over 80 foreign patents to his credit and is one of the co-developers of the NOxMaster™ technology. Mr. Berriman is also very closely aligned with the California Air Resources Board (CARB) and the South Coast Air Quality Management District (AQMD).

Lionel Simons, President and Secretary. Mr. Simons attended the London School of Economics where he earned his Bachelor of Science in Economics and was awarded one of 7 Leverhume Scholarships. He earned his Masters in Business Administration, majoring in International Business and Marketing, at the Columbia University Graduate School of Business. While Managing Director of Denbyware Ltd. of England, a manufacturing Company with over 1,000 employees, he increased sales from \$10 million to \$25 million and took the Company public via the London Stock Exchange. As President of Dunn Systems, a medical imaging manufacturing Company with over 150 employees, he increased OEM sales from \$3 million to \$15 million before merging with a major NASDAQ Company. He spent 2 years with Thunder Engine Company, developers of a 600 hp heavy duty multi- fuel light-weight aluminum engine, and successfully concluded technology transfer agreements with companies in China, Korea and Canada.

Hamid Servati, Vice Chairman. Dr. Servati attended the University of California at Santa Barbara where he earned his undergraduate degrees and his Doctorate in Engineering. He then worked as a contract consulting engineer to Ford Motor Company in Detroit from 1984 to 1987 when he founded ServoTech, of which he is President and CEO.

He became a tier one supplier to Ford in 1989, providing a variety of consulting engineering services. He also founded ServoTech Industries, Inc., a manufacturer of prototypes and high precision components for the automotive and related industries.

#### Item 10. Executive Compensation

Mr. Berriman, Mr. Simons and Mr. Zabsky voluntarily terminated employment and consulting contracts with the Company in mid-1996 and the Company, with their consent, also terminated a stock option and compensation plan for Directors. In 2001, the Company awarded the following non-cash stock compensation for services rendered:

##### (a) SUMMARY COMPENSATION TABLE

Names and Principle Positions	Year	Annual Compensation			Market Value
		Salary	Bonus	Other Annual Compensation	
Lionel Simons President/Secretary	2003	\$ -0-	\$ -0-	5,000,000 shares	\$346,500
	2002	-0-	-0-	None	-0-
	2001	-0-	-0-	300,000 shares	27,720
Lester Berriman Chairman/ VP-Research	2003	\$ -0-	\$ -0-	1,000,000 shares	\$ 76,600
	2002	-0-	-0-	None	-0-
	2001	-0-	-0-	300,000 shares	27,720
William H. Ward, Jr. Director/Consultant	2003	N/A	N/A	N/A	
	2002	N/A	N/A	N/A	
	2001	-0-	-0-	300,000 shares	27,720 (1)
Hamid Servati Director/Vice Chairman	2003	\$ -0-	\$ -0-	None	\$ -0-
	2002	-0-	-0-	500,000 shares	87,500 (2)
	2001	N/A	N/A	N/A	
John Zabsky d.b.a. John Z Co. Consultant	2003	\$10,000	\$ -0-	500,000 shares	\$ 34,650 (1)
	2002	24,000	-0-	None	-0- (1)
	2001	24,000	-0-	200,000 shares	18,480 (1)

(1) Compensation was provided to Mr. Zabsky and Mr. Ward as an outside consultant.

(2) Mr. Servati was issued 500,000 shares valued at \$87,500 prior to becoming a director as part of an attempt to acquire 51% of two entities that he owns.

##### (b) OPTION/STOCK APPRECIATION RIGHTS

No stock options were granted during 2003 or free standing SARs to executive officers of the Company.

##### (c) AGGREGATED OPTION/SAR EXERCISES AND FISCAL YEAR END OPTION/SAR VALUE TABLE

There was no exercise during 2003 of stock options and free standing SARs by executive officers of the Company.

##### (d) LONG TERM INCENTIVE PLAN ("LITP") AWARDS TABLE

The Company did not make any long-term incentive plan awards to any executive officer in 2003.

(e) COMPENSATION OF DIRECTORS

No Directors of the Company received cash compensation for their services as Director during 2003.

(f) EMPLOYMENT CONTRACTS

The Company has no employment contracts with executive officers.

**Item 11. Security Ownership of Certain Beneficial Owners and Management**

The following table sets forth a list of persons known to the Company to be the beneficial owner of more than five percent of the Company's voting stock.

<u>Title of Class</u>	<u>Name and Address of Beneficial Owner</u>	<u>Amount of Beneficial Ownership</u>	<u>Percent of Class</u>
Common	Pollution Control, Inc. 328 Bay street Nassau, Bahamas	9,993,877	23.71%
Common	Lionel Simons, 36 Corniche Drive Dana Point, CA 92629	714,808 (2)(3)	1.70%
Common	Lester Berriman 18871 Portofino Drive Irvine, CA 92715	2,362,048	5.60%
Common	Prudent Bear Funds, Inc. 8140 Walnut Hill Lane Suite 405 Dallas, TX 75231	3,141,045	7.45%
Common	John Zabsky 3640 S Main St Santa Ana, CA 92707	1,680,432 (4)	3.99%

- (1) All shares presented are common shares. No preferred shares were outstanding at December 31, 2003.
- (2) Lionel Simons maintains an indirect controlling beneficial interest in Pollution Control, Inc. through a family trust. See item 12.
- (3) Total shares reported as held by Lionel Simons includes 20,000 shares held by Kimberly Simons who is his daughter and 9,800 shares held by Barbara J. Simons who is his wife.
- (4) This total represents shares held by Mr. Zabsky in his own name, as well as shares held by John Z Company, a corporation wholly owned by Mr. Zabsky.

The following table sets forth a list of the beneficial ownership in the Company by officers and directors.

<u>Title of Class</u>	<u>Name and Address of Beneficial Owner</u>	<u>Amount of Beneficial Ownership</u>	<u>Percent of Class</u>
Common	Lionel Simons 36 Corniche Drive Dana Point, CA 92629	10,708,685 (2)(3) (4)	25.40%
Common	Lester Berriman 18871 Portofino Drive Irvine, CA 92715	2,362,048	5.60%
Common	Hamid Servati 510 Savage Road Belleville, Mi 48111	1,000,000	2.37%
Common	All officers and directors as a group:	14,070,733 (5)	33.38%

- (1) All shares presented are common shares. No preferred shares were outstanding at December 31, 2003.
- (2) Lionel Simons maintains an indirect controlling beneficial interest in Pollution Control, Inc. through a family trust. See item 12.
- (3) Total shares reported as held by Lionel Simons includes 20,000 shares held by Kimberly Simons who is his daughter and 9,800 shares held by Barbara J. Simons who is his wife.
- (4) Due to the controlling interest in Pollution Control, Inc. held by Lionel Simons, shares held by Pollution Control have been attributed to him for purposes of this total.
- (5) At December 31, 2002, Mr. Ward was no longer a director. His shares have been excluded from the total presented for all officers and directors as of that date.

#### **Item 12. Certain Relationships and Related Transactions**

Lionel Simons, President of KleenAir Systems, Inc. is also President and a beneficial owner of Pollution Control Inc. through family trusts. Mr. Simons has a Power of Attorney from Pollution Control which permits him to vote on its behalf.

See also the discussion of related party transactions presented at Note 14 to the financial statements.

#### **Item 13. Exhibits and Reports on Form 8-K**

- (a) The following documents are filed as a part of this report or are incorporated by reference.

Financial Statements -- The following information has been included in response to Item 8.

	<u>Page</u>
- Report of Independent Certified Public Accountants	F-2
- Consolidated Balance Sheets	F-3
- Consolidated Statements of Operations	F-4
- Consolidated Statements of Shareholders' Equity	F-5
- Consolidated Statements of Cash Flows	F-8
- Notes to Consolidated Financial Statements	F-9

Exhibits - The following Exhibits are furnished as a part of this report:

<u>Exhibit No.</u>	<u>Description</u>
23.1	* Consent of Robert Early & Company, P.C.
31	* Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	* Certification of Chief Operating Officer pursuant to Section 906 of Sarbanes Oxley Act
32.2	* Certification of Chief Financial Officer pursuant to Section 906 of Sarbanes-Oxley Act

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\* Filed herewith.

(b) Reports on Form 8-K

None

**Item 14. Principal Accountant Fees and Services**

As of the date of this Report, the Company has not appointed members to an audit committee and, therefore, the respective role of an audit committee has been conducted by the board of directors of the Company. When established, the audit committee's primary function will be to provide advice with respect to the Company's financial matters and to assist the board of Directors in fulfilling its oversight responsibilities regarding finance, accounting, tax and legal compliance. The audit committee's primary duties and responsibilities will be to: (i) serve as an independent and objective party to monitor the Company's financial reporting process and internal control system; (ii) review and appraise the audit efforts of the Company's independent accountant's; (iii) evaluate the Company's quarterly financial performance as well as its compliance with laws and regulations; (iv) oversee management's establishment and enforcement of financial policies and business practices; and (v) provide an open avenue of communication among the independent accountants, management and the board of directors.

The firm of Robert Early & Company, P.C., served as the Company's independent auditors for the years ended December 31, 2003 and 2002. The Board of Directors of the Company, in its discretion, may direct the appointment of different public accountants at any time during the year, if the Board believes that a change would be in the best interests of the stockholders. The Board of Directors has considered the audit fees, audit-related fees, tax fees and other fees paid to the Company's accountants, as disclosed below, and had determined that the payment of such fees is compatible with maintaining the independence of the accountants.

**Audit and Audit-Related Fees:** The aggregate fees, including expenses, billed by the Company's principal accountant in connection with the audit of our consolidated financial statements for the most recent fiscal year included in our Annual Report on Form 10-KSB; and for the review of our financial information and our quarterly reports on Form 10-QSB during the years ending December 31, 2003 and 2002 were \$19,049 and \$12,191, respectively. In addition, we incurred accounting review related fees (primarily related to procedures our auditors were required to perform in reviewing potential registration statements and our Form S-8 Registration Statements) of \$1,384 in 2003 and \$1,640 in 2002, respectively.

**Tax Fees:** The Company did not incur any fees for tax compliance, tax advice and tax planning by the Company's principal accountant for 2003 and 2002.

**All Other Fees:** The Company paid its principal accountant \$2,500 and \$3,255 in 2003 and 2002, respectively, for the services of converting its SEC filings to and filing them in EDGAR format.

## SIGNATURES

In accordance with Section 13 or 15 (d) of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

KLEENAIR SYSTEMS, INC.

Date: April 14, 2004

/s/ LIONEL SIMONS  
By: Lionel Simons., President,  
Secretary, Principal Accounting  
Officer, & Principal Financial Officer

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ LIONEL SIMONS</u> Lionel Simons	Director	April 14, 2004
<u>/s/ LESTER BERRIMAN</u> Lester Berriman	Director	April 14, 2004
<u>/s/ HAMID SERVATI</u> Hamid Servati	Director	April 14, 2004

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)

**INDEX TO FINANCIAL STATEMENTS**

Report of Independent Certified Public Accountants . . . . .	F-2
Consolidated Balance Sheets as of December 31, 2003 and 2002 . . . . .	F-3
Consolidated Statements of Operations for the years ended December 31, 2003 and 2002 . . . . .	F-4
Consolidated Statement of Stockholders' Equity for the years ended December 31, 2003 and 2002 . . . . .	F-5
Consolidated Statements of Cash Flows for the years ended December 31, 2003 and 2002 . . . . .	F-7
Notes to Consolidated Financial Statements . . . . .	F-8

## **REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS**

Board of Directors  
KleenAir Systems, Inc.  
Irvine, California

We have audited the accompanying consolidated balance sheets of KleenAir Systems, Inc. (a development stage Company) as of December 31, 2003 and 2002, and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended. We have also audited the cumulative statements of operations, stockholders' equity, and cash flows for the period from January 1, 1995 through December 31, 2003. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of KleenAir Systems, Inc. at December 31, 2003 and 2002, and the results of its operations and its cash flows for the years and cumulative period then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 2 to the financial statements, the Company is still in the development stage and has not established sustained operating revenues. This situation raises substantial doubt as to the Company's ability to continue as a going concern. Management's plans in regard to this situation are also described in Note 2. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ ROBERT EARLY & COMPANY, P.C.  
Robert Early & Company, P.C.  
Abilene, Texas

March 22, 2004



**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
**CONSOLIDATED BALANCE SHEETS**  
As of December 31, 2003 and 2002

ASSETS

	<u>2003</u>	<u>2002</u>
<b>CURRENT ASSETS:</b>		
Cash	\$ 28,739	\$ 76,758
Accounts receivable	15,699	12,542
Accounts receivable from related parties	33,288	50,000
Advances	-	52,000
Parts inventory (at cost)	57,126	114,076
Prepaid expenses	47,000	121,542
Loans to licensee	<u>-</u>	<u>220,000</u>
Total Current Assets	181,852	646,918
PROPERTY AND EQUIPMENT (net)	155,611	195,620
<b>OTHER ASSETS:</b>		
Patent license (net)	<u>1,530,756</u>	<u>1,617,380</u>
<b>TOTAL ASSETS</b>	<u><u>\$ 1,868,219</u></u>	<u><u>\$ 2,459,918</u></u>

LIABILITIES AND STOCKHOLDER'S EQUITY

<b>CURRENT LIABILITIES:</b>		
Accounts payable (\$84,358 and \$69,534 due to related parties, respectively)	\$ 504,749	\$ 150,176
Advances from directors	96,584	95,850
Capital lease liability	372	4,811
Note payable to related entity	<u>197,000</u>	<u>50,000</u>
Total Current Liabilities	<u>798,705</u>	<u>300,837</u>
<b>STOCKHOLDERS' EQUITY:</b>		
Preferred stock, series A, \$.001 par value (10,000,000 shares authorized, none outstanding)	-	-
Common stock, \$.001 par value (50,000,000 shares authorized, 31,422,161 and 20,270,556 outstanding, respectively)	31,422	20,271
Additional paid-in capital	8,006,296	6,959,717
Deficit accumulated during the development stage	<u>(6,968,204)</u>	<u>(4,820,907)</u>
Total Stockholder's Equity	<u>1,069,514</u>	<u>2,159,081</u>
<b>TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY</b>	<u><u>\$ 1,868,219</u></u>	<u><u>\$ 2,459,918</u></u>

The accompanying notes are an integral part of these financial statements.

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
For Years Ended December 31, 2003 and 2002

	<u>2003</u>	<u>2002</u>	Cumulative During Devel- opment Stage
REVENUES			
Sales	\$ 734,993	\$ 51,235	\$ 910,016
Royalties	<u>19,892</u>	<u>-</u>	<u>19,892</u>
Total revenues	754,885	51,235	929,908
COST OF REVENUES	<u>647,876</u>	<u>50,461</u>	<u>698,337</u>
Gross Profit	<u>107,009</u>	<u>774</u>	<u>231,571</u>
PRODUCT DEVELOPMENT COSTS	196,534	337,773	1,239,005
OPERATING EXPENSES:			
Personnel costs	570,445	84,697	1,237,744
Consultants	682,796	439,185	2,726,726
Professional fees	103,536	162,276	499,227
Office expenses	9,915	17,738	53,278
Depreciation	49,690	33,579	111,520
Amortization of intangible assets	116,148	65,511	181,659
Advertising and promotion	19,177	57,552	230,941
Loss on cancellation of licensing agreements	-	-	19,860
Rent	95,717	63,250	210,217
Travel	96,575	94,874	296,573
Other expenses	76,536	71,562	167,157
Bad debts	220,000	-	220,000
Unknown losses under prior ownership	-	-	151,518
Total operating expenses	<u>2,040,535</u>	<u>1,090,224</u>	<u>6,106,420</u>
(LOSS) FROM OPERATIONS	(2,130,060)	(1,427,223)	(7,113,854)
OTHER INCOME AND (EXPENSES):			
Interest income	11	15	2,526
Interest expense	(17,248)	(2,189)	(19,437)
Amortize discount on receivables	<u>-</u>	<u>-</u>	<u>20,259</u>
(Loss) before income taxes	(2,147,297)	(1,429,397)	(7,110,506)
Benefit from Deferred taxes	<u>-</u>	<u>397,852</u>	<u>397,852</u>
<b>(Loss) Before Extraordinary Item</b>	<b>(2,147,297)</b>	<b>(1,031,545)</b>	<b>(6,712,654)</b>
Extraordinary Item:			
Costs of terminated acquisitions	<u>-</u>	<u>(87,500)</u>	<u>(255,550)</u>
Net (Loss)	<u><u>\$ (2,147,297)</u></u>	<u><u>\$ (1,119,045)</u></u>	<u><u>\$ (6,968,204)</u></u>
Earnings per Share (Basic):			
(Loss) Per Share Before Extraordinary Item	\$ (0.10)	\$ (0.06)	\$ (0.79)
(Loss) Per Share From Extraordinary Item	<u>-</u>	<u>-</u>	<u>(0.03)</u>
Net (Loss) Per Share	<u><u>\$ (0.10)</u></u>	<u><u>\$ (0.06)</u></u>	<u><u>\$ (0.82)</u></u>
Weighted Average Shares Outstanding			
Basic	<u><u>22,392,964</u></u>	<u><u>17,729,544</u></u>	<u><u>8,528,986</u></u>

The accompanying notes are an integral part of these financial statements.

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

	Preferred Stock		Common Stock		Additional	Unearned	Accumulated
	Shares	Amount	Shares	Amount	Paid-In Capital	Compensation	Deficit During Development Stage
BALANCES, 1/1/95	-	\$ -	74,132	\$ 74	\$ 151,444	\$ -	\$ (151,518)
Stock issued: For cash	-	-	27,334	27	66,982	-	-
For adjustment	-	-	534	1	-	-	-
For consulting services	-	-	86,148	86	279,439	-	-
For professional services	-	-	4,666	5	12,745	-	-
For purchase of patent rights	933,334	934	60,000	60	13,905	-	-
For directors' compensation	-	-	4,000	4	22,496	-	-
For officers' compensation	33,334	33	9,334	9	194,958	-	-
Other contributed capital	-	-	-	-	2,367	-	-
Options compensation	-	-	-	-	70,313	(152,016)	-
Net loss	-	-	-	-	-	-	(329,289)
BALANCES, 12/31/95	966,668	967	266,148	266	814,649	(152,016)	(480,807)
Stock issued: For services	13,332	13	24,666	25	201,837	(78,750)	-
For officers' compensation	33,332	33	-	-	15,592	(15,625)	-
For aborted acquisition	-	-	40,000	40	140,510	-	-
Exercise of options	-	-	75,000	75	112,424	-	-
Conversion to common	(318,666)	(319)	318,666	319	-	-	-
Net Loss	-	-	-	-	-	187,346	(716,511)
BALANCES, 12/31/96	694,666	694	724,480	725	1,285,012	(59,045)	(1,197,318)
Stock issued: For cash	-	-	120,000	120	14,880	-	-
For officers' compensation	33,334	33	-	-	3,842	(3,875)	-
Conversion to common	(100,000)	(100)	100,000	100	-	-	-
Net loss	-	-	-	-	-	37,979	(55,438)
BALANCES, 12/31/97	628,000	627	944,480	945	1,303,734	(24,941)	(1,252,756)

(Continued on next page)

The accompanying notes are an integral part of these financial statements.

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(Continued from previous page)

	Preferred Stock		Common Stock		Additional	Unearned	Accumulated
	Shares	Amount	Shares	Amount	Paid-In	Compen-	Deficit During
					Capital	sation	Development
							Stage
Stock issued: For cash	-	-	800,000	800	199,200	-	-
For services	-	-	2,120,000	2,120	92,255	-	-
To officers and directors	-	-	320,000	320	59,680	-	-
For diesel license	-	-	2,000,000	2,000	60,500	-	-
Conversion to common	(403,334)	(403)	403,334	403	-	-	-
Net loss	-	-	-	-	-	24,941	(305,561)
BALANCES, 12/31/98	224,666	224	6,587,814	6,588	1,715,369	-	(1,558,317)
Stock issued: For cash	-	-	146,800	147	35,653	-	-
For services	-	-	1,103,334	1,103	247,179	-	-
For equipment	-	-	33,200	33	8,267	-	-
To officers and directors	-	-	1,425,000	1,425	408,808	-	-
Conversion to common	(61,334)	(61)	61,334	61	-	-	-
Net loss	-	-	-	-	-	-	(802,722)
BALANCES, 12/31/99	163,332	163	9,357,482	9,357	2,415,276	-	(2,361,039)
Stock issued: For cash	-	-	1,414,000	1,414	357,336	-	-
For services	-	-	1,642,666	1,643	600,024	-	-
As promotion	-	-	1,600	2	3,199	-	-
Conversion to common	(163,332)	(163)	163,334	163	-	-	-
Net loss	-	-	-	-	-	-	(717,012)
BALANCES, 12/31/00	-	-	12,579,082	12,579	3,375,835	-	(3,078,051)
Stock issued: For cash	-	-	195,000	195	104,805	-	-
For services	-	-	1,749,487	1,749	293,087	-	-
To officers and directors	-	-	850,000	850	77,690	-	-
For rent	-	-	17,500	18	6,232	-	-
Net loss	-	-	-	-	-	-	(623,811)
BALANCES, 12/31/01	-	-	15,391,069	15,391	3,857,649	-	(3,701,862)

(Continued on next page)

The accompanying notes are an integral part of these financial statements.

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(Continued from previous page)

	Preferred Stock		Common Stock		Additional	Unearned	Accumulated
	Shares	Amount	Shares	Amount	Paid-In	Compensation	Deficit During
					Capital		Development
							Stage
Stock issued: For cash	-	-	2,804,545	2,805	1,717,195	-	-
For services	-	-	1,201,692	1,202	404,232	-	-
For Acquisition of Carbon Cloth	-	-	873,250	873	968,434	-	-
Contributed inventory	-	-	-	-	12,207	-	-
Net loss	-	-	-	-	-	-	(1,119,045)
BALANCES, 12/31/02	-	-	20,270,556	20,271	6,959,717	-	(4,820,907)
Stock issued:							
For cash	-	-	750,000	750	74,250	-	-
To officers and directors	-	-	7,600,000	7,600	511,490	-	-
For services	-	-	2,801,605	2,801	460,839	-	-
Net loss	-	-	-	-	-	-	(2,147,297)
BALANCES, 12/31/03	-	\$ -	31,422,161	\$ 31,422	\$ 8,006,296	\$ -	\$ (6,968,204)

The accompanying notes are an integral part of these financial statements.

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
For Years Ended December 31, 2003 and 2002

	<u>2003</u>	<u>2002</u>	<u>Cumulative During Devel- opment Stage</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net (loss)	\$(2,147,297)	\$(1,119,045)	\$ (6,968,204)
Adjustments to reconcile net (loss) to net cash provided by operations:			
Losses prior to current ownership	-	-	151,518
Depreciation	49,690	33,579	111,520
Bad debts	220,000	-	220,000
Amortization of:			
Prepaid expenses	136,042	170,270	1,224,737
Intangibles	116,148	65,511	181,659
Stock issued for services	921,230	192,184	2,761,872
Stock issued for extraordinary loss	-	87,500	140,550
Deferred income taxes	-	(397,852)	(397,852)
Changes in operating assets and liabilities:			
Accounts receivable	65,555	(90,545)	(26,590)
Inventory	56,950	(91,538)	(34,588)
Advances to consultants	-	-	20,000
Prepaid expenses	-	(46,200)	(247,000)
Trade accounts payable	<u>354,573</u>	<u>(41,899)</u>	<u>408,605</u>
<b>NET CASH USED BY OPERATING ACTIVITIES</b>	<u>(227,109)</u>	<u>(1,238,035)</u>	<u>(2,453,773)</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Property and equipment	(9,681)	(172,570)	(257,438)
Patent licensing costs	(29,524)	(56,107)	(161,012)
Business acquisition	-	(44,820)	(44,820)
Notes receivable	<u>-</u>	<u>(220,000)</u>	<u>(220,000)</u>
<b>NET CASH USED IN INVESTING ACTIVITIES</b>	<u>(39,205)</u>	<u>(493,497)</u>	<u>(683,270)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from issuing stock	75,000	1,720,000	2,869,459
Capital lease obligation	-	7,765	7,765
Payments on capital lease	(4,439)	(2,954)	(7,393)
Additional capital contributions	-	-	2,367
Advances and loans from related parties	<u>147,734</u>	<u>50,000</u>	<u>293,584</u>
<b>NET CASH PROVIDED BY FINANCING ACTIVITIES</b>	<u>218,295</u>	<u>1,774,811</u>	<u>3,165,782</u>
<b>NET INCREASE/(DECREASE) IN CASH</b>	(48,019)	43,279	28,739
<b>CASH AT BEGINNING OF YEAR</b>	<u>76,758</u>	<u>33,479</u>	<u>-</u>
<b>CASH AT END OF YEAR</b>	<u><u>\$ 28,739</u></u>	<u><u>\$ 76,758</u></u>	<u><u>\$ 28,739</u></u>

See Note 3 for Supplemental Cash Flow Disclosures

The accompanying notes are an integral part of these financial statements.

**KLEENAIR SYSTEMS, INC.**  
(A Development Stage Company)  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
December 31, 2003 and 2002

**NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING PRINCIPLES**

**NATURE OF BUSINESS**

KleenAir Systems, Inc. (the Company) was originally incorporated in 1986 in Nevada as Covington Capital Corporation. The Company has had various names during its existence as various endeavors were attempted. None of these proved fruitful. The Company was most recently known as Investment & Consulting International, Inc. until April 1995. At that time, the Company purchased a patent for a proprietary device shown to be capable of neutralizing the environmental impact of nitrous oxide from the emissions from automobile exhaust without significant modification to the vehicle. This device is known as the "NOxMaster™." Soon after the acquisition of this patent and the right to use of the seller's name, the Company changed to its current name. With the patent acquisition in April 1995, the Company moved into the development stage and has since worked toward the completion of tests, fine tuning, and clearance of California Air Resources Board standards.

During April 2002, the Company acquired Carbon Cloth Technologies, Inc. (Carbon Cloth). Carbon Cloth owns the exclusive rights to manufacture and market automotive thermal management systems. Certain applications of the Company's NOxMaster™ are enhanced by the addition of the main product offered by Carbon Cloth. The sharing of Carbon Cloth's customer base and contacts in connection with the compatibility and joint benefits of the mutual products are expected to enhance sales of both products.

The Company's accounting and reporting policies conform with generally accepted accounting principles. Policies that materially affect the determination of financial position, cash flows, and results of operations are summarized as follows:

Development stage reporting -- Generally accepted accounting principles call for certain presentations of cumulative financial statement information from inception to the date of the financial statements. Since the Company restarted its operations (from a position of inactivity) in April 1995, these statements present information from the inception of its development stage.

Consolidation -- The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, after elimination of all material intercompany accounts, transactions, and profits.

Investments in Closely Held Entities -- The equity method of accounting is used when the Company has a 20% to 50% interest in other entities. Under the equity method, original investments are recorded at cost and adjusted by the Company's share of undistributed earnings or losses of these entities.

Accounts Receivable -- The Company uses the allowance method to account for uncollectible accounts receivable. Accounts receivable are presented net of an allowance for doubtful accounts when applicable. There were no allowances at December 31, 2003 or 2002.

Inventory -- Inventories are stated at the lower of cost or market (net realizable value).

Property and Equipment -- Property and equipment are carried at depreciated cost. Expenditures for major renewals and betterments that extend the useful lives are capitalized. Expenditures for maintenance and repairs are charged to expense as incurred. The cost of property and equipment is depreciated over the estimated useful lives of the related asset. Depreciation is computed on the straight-line method for financial reporting purposes and on the applicable Modified Accelerated Cost Recovery System method for income tax purposes. In addition, tax depreciation includes the benefits of first year expensing under Internal Revenue Code Section 179 whenever it is advantageous to the Company make this election.

Patent and Licensing Costs -- Only the direct costs of obtaining license or patents and costs of extending or perfecting the patents are available for capitalization. These capitalized costs are amortized over the estimated useful life of the patent, generally five to fifteen years, using the straight-line method. The cost of patent applications in process is not amortized until patents are issued. In the event of a patent being superseded, the unamortized

costs are written off immediately. All costs of research and development are charged to operations as development costs when incurred and are included in results of operations.

The Company purchased the rights to the patent for its NOxMaster™ and developed other patents as discussed at Note 7 below. The cost of the patent and licenses, along with legal costs incurred to register and protect them, have been capitalized and are being amortized now that sales of the product have commenced. Amortization is being charged on a straight-line basis over ten years beginning April 2003. Amortization expense of \$17,881 related to these rights has been charged to operations.

The acquisition cost allocated to the CarbonGuard™ (Carbon Cloth's intangible asset) is being amortized over fifteen years beginning May 2002. Amortization expense for this asset of \$98,267 has been charged to operations during 2003.

Revenue Recognition -- Sales are recorded when products are shipped to customers. Provisions for discounts and rebates to customers, estimated returns and allowances, and other adjustments are provided for in the same period the related sales are recorded. In instances where products are configured to customer requirements, revenue is recorded upon the successful completion of the Company's final test procedures.

Research and Development Costs -- Research, development, and engineering costs are expensed in the year incurred. Costs incurred are as disclosed in the income statement.

Stock-Based Compensation -- The Company accounts for services acquired using stock as compensation based on the fair value of the shares issued. Fair value is determined based on the closing price of the stock on the date the Company becomes obligated to issue the shares. Due to thin trading volume of the Company's stock, most stock issuances are recorded at a discount to the market price due to effective limitations on disposal by the recipient of the shares. Restricted shares issued for services are discounted at a greater discount due to the added limitation of the holding period for the restricted shares.

Income Taxes -- The Company accounts for income taxes in accordance with FASB Statement No. 109, "Accounting for Income Taxes." Under FAS 109, deferred income tax assets and liabilities are recorded for the income tax effects of differences between the bases of assets and liabilities for financial reporting purposes and their bases for income tax reporting. The Company's differences arise principally from the use of accelerated and modified accelerated cost recovery system for income tax purposes versus straight line depreciation and from utilization of net operating loss carry-forwards.

Deferred tax assets and liabilities are the amounts by which the Company's future income taxes are expected to be impacted by these differences as they reverse. Deferred tax assets are based on differences that are expected to increase future income taxes as they reverse. Correspondingly, deferred tax liabilities are based on differences that are expected to increase future income taxes as they reverse. Note 6 below discusses the amounts of deferred tax benefits and deferred tax liabilities. The Note also presents the impact of significant differences between financial reporting income and taxable income.

Earnings Per Share -- In February 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 128 "Earnings Per Share," which requires the Company to present basic and diluted earnings per share, instead of the primary and fully diluted earning per share. The computation of basic earning per share is based on the weighted average number of common shares outstanding during the periods presented. The computation of diluted earnings per shares is based on the weighted average number of outstanding common shares during the year plus, when their effect is dilutive, additional issuable shares, assuming the exercise of certain vested and non-vested stock options and warrants and conversion rights, reduced by the number of shares that could be purchased from any proceeds generated.

Cash Flows -- The Company considers cash to be its only cash equivalent for purposes of presenting its Statements of Cash Flows.

Accounting Estimates -- The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.



**NOTE 2: GOING CONCERN**

These financial statements have been prepared assuming that the Company will continue as a going concern. The Company has neither sufficient operating revenues nor disposable assets to fund completion of its development program, current level of expenses, or initial production stages. In this situation, the Company is reliant solely upon its ability to raise capital through sales of its stock, debt financing, or acquisition of services through issuances of the Company's stock. There is no assurance that a market exists for the sale of the Company's stock or that lenders could be found to lend money to the Company. Should financing not be available, the Company would, in all likelihood, be forced to stop development efforts and/or to shut down its activities completely.

Management has been in contact with various parties who are interested in providing funding for the completion of testing and trials to obtain certifications from the State of California and the EPA regarding the product's ability to function as an emission control device. Because of these contacts, Management anticipates that efforts to obtain certification will be continued and that there should be no substantial difficulties in obtaining sufficient financing to obtain such certifications and subsequent distribution. Additionally, testing in England has resulted in product sales and installations during the second and third quarters of 2003 through the Company's U.K. affiliate. Sales/ installations were halted for the fourth quarter of 2003 and the first quarter of 2004 due to budgetary limitations under the U.K. trust administering the government cost sharing program. These sales are expected to resume in April with the advent of a new budget period. Additionally, subsequent to year end, the Company has executed an exchange of its newly issued restricted shares for free trading shares of a U.K. investment fund. The sale of these shares should provide much needed funds to pursue California testing while also resuming sales in the U.K..

These financial statements do not include any adjustments relating to the recoverability and classification of recorded asset amounts or the amount of liabilities that might be necessary should the Company be unable to continue in existence.

**NOTE 3: SUPPLEMENTAL CASH FLOW DISCLOSURES:**

	<u>2003</u>	<u>2002</u>	<u>Cumulative During Devel- opment Stage</u>
Cash payments for:			
Interest	\$ 6,075	\$ 2,189	\$ 8,264
Income taxes	-	-	-
Non-cash investing and financing transactions (Stock has been issued for the following):			
Compensation and directors' fees	\$ 519,090	\$ 92,912	\$ 1,338,650
Consultants and prepaid services	463,640	225,022	2,154,397
Equipment	-	-	8,300
Patent licensing	-	-	14,900
Repurchase of U.S. diesel license	-	-	62,500
Acquisition of National Diversified Telecom, Inc.	-	-	140,550
Sale of marketing licenses for notes receivable	-	-	1,736,558
Acquisition of Carbon Cloth Technologies, Inc.	-	981,514	981,514
Uncompleted business acquisition	-	87,500	87,500

**NOTE 4: EQUITY METHOD INVESTEE**

The Company holds a 30% interest in KleenAir Systems International, Inc. (KASI), a Bahamas based entity. KASI owns 100% of KleenAir Systems, Ltd. (KSL), a British entity. The Company received its interest in KASI pursuant to a licensing agreement with its President for European marketing rights for its products. As such, the Company has no cost in this investment. To date, KASI has not generated any net profit. Accounting rules do not provide for recording negative investments under equity method accounting.

## NOTE 5: RECEIVABLES

During 2002, the Company advanced \$45,000 to KSL for expenses incurred in the testing of the product on London taxicabs and buses. KSL was awarded a portion of a U.K. government-funded grant for this testing. During 2003, KSL paid a consultant the equivalent of \$7,791 for consulting services related to countries other than Great Britain. As agreed by Management, this payment was offset against the outstanding receivable, leaving an outstanding balance due of \$37,209. The Company owes KASI \$3,921 due to funds collected directly from KSL for product sales in excess of amounts due from KASI.

A consultant was advanced \$5,000 during 2002. This advance was offset against compensation due the consultant in 2003.

An advance of \$52,000 was provided to one of the principles of Carbon Cloth during 2002 against stock to be issued to him under his employment agreement. This receivable was offset against compensation during 2003.

During the first quarter of 2002, the Company loaned \$120,000 to a licensee. This loan is secured by 100,000 shares of the Company's stock and was expected to be satisfied before the end of the year. During the third quarter of 2002, the Company loaned this same entity another \$100,000 secured by 120,000 shares of the Company's stock. The first loan and the related stock were later assigned to a third party by the licensee. No date has been set for repayment by the third party.

During 2003, the Company negotiated a settlement with the licensee for them to relinquish exclusivity to certain geographical areas and types of customers in exchange for the Company releasing its claim for repayment of the loans or return of the stock. As a result, these loans were written off.

## NOTE 6: PREPAID EXPENSES

The Company follows a practice of employing consultants for advisory services. Typically, these agreements are for one year periods and generally call for the bulk of their compensation to be paid with stock at the initiation of the services. The stock compensation under these contracts is valued at its estimated fair value based on the trading price at the start of the contract and recorded as prepaid services. This prepaid cost is then amortized to consulting fees over the period of the contract.

In 2002, the Company started contracts with a combination of unrestricted and restricted stock valued at a total of \$125,750. In 2003, the Company prepaid \$61,500 with unrestricted stock. All consulting agreements had fully amortized before December 31, 2003. Amortization of these costs during 2003 and 2002 was \$170,270 and \$39,688, respectively. Balances of items making up prepaid expenses at December 31, 2003 and 2002 were as follows:

	<u>2003</u>	<u>2002</u>
Consulting agreements	\$ -	\$ 74,542
Rent	46,200	46,200
Taxes	<u>800</u>	<u>800</u>
Totals	<u>\$ 47,000</u>	<u>\$ 121,542</u>

## NOTE 7: FEDERAL INCOME TAXES

Because of timing, relative insignificance, and changes in control and management, the Company believes that it cannot benefit from operating losses before 1995 in calculating its income taxes. Operating losses reported for tax purposes vary from accumulated deficits in retained earnings due to differences in tax treatment, deductibility, or timing of various items. The tax loss carry-forwards are as follows:

<u>Year of Expiration</u>	<u>Amount of Net Operating Loss Carry Forward</u>
2010	\$ 148,187
2011	901,206
2012	79,438
2018	305,825
2019	804,046
2020	720,022
2021	626,785
2022	1,460,856
2023	<u>2,282,759</u>
	<u>\$ 7,329,124</u>

The Company has deferred tax assets and liabilities at December 31, 2003 and 2002. These have arisen from the difference in the depreciation deduction for book and tax purposes, from operating loss carry-forwards, from the difference between the tax and book bases for the patent acquisition, and from the acquisition of Carbon Cloth. These result in net deferred tax assets totaling \$3,838,980 and \$2,987,430 at December 31, 2003 and 2002, respectively. However, because management is unable to determine at this point that it is more likely than not that the Company will be able to utilize these deductions against future revenues, a valuation allowance has been recorded to offset the assets. There is no current income tax benefit or expense to be reported for the periods ended December 31, 2003 and 2002. The following table sets forth the reconciling items between income per books and taxable income.

	<u>2003</u>	<u>2002</u>
Book loss	\$ (2,147,297)	\$ (1,119,045)
Deferred tax benefit	-	(397,852)
Non deductible expenses	9,658	7,116
Depreciation	876	1,098
Amortization of intangibles	<u>(145,996)</u>	<u>47,829</u>
Taxable loss	<u>\$ (2,282,759)</u>	<u>\$ (1,460,854)</u>

Deferred tax liabilities arise primarily from the use of accelerated methods of depreciation of property and equipment for tax purposes and from differences in the tax and book bases for the patents (including the Carbon Cloth acquisition). The Company's deferred tax liabilities and assets are as set out below:

	<u>2003</u>	<u>2002</u>
Deferred tax assets:		
Patent costs	\$ 1,286,124	\$ 1,390,404
Net operating losses	<u>2,918,217</u>	<u>2,008,958</u>
Total	<u>4,204,341</u>	<u>3,399,362</u>
Deferred tax liabilities:		
Property and equipment	2,204	2,553
Investment in Carbon Cloth	<u>363,216</u>	<u>409,375</u>
Total	<u>365,420</u>	<u>411,928</u>
Net deferred tax asset	3,838,921	2,987,434
Valuation allowance	<u>(3,838,921)</u>	<u>(2,987,434)</u>
Amount reported on Balance Sheet	<u>\$ -</u>	<u>\$ -</u>

In 2002, the Company acquired Carbon Cloth Technologies, Inc. in an exchange of stock. In recording that acquisition, the Company was required to recognize a deferred tax liability for the difference in the book basis

(acquisition cost) of Carbon Cloth and its tax basis. The same rules for deferred taxes require that the liability be offset by deferred tax assets if they exist. When this was done, a benefit was realized because the Company has previously (and prospectively) maintained a valuation allowance against its deferred tax assets because of its inability to foresee the timing of their utilization.

#### **NOTE 8: PATENTS, LICENSE, RESEARCH AND DEVELOPMENT**

During April 1995, the Company acquired a patent for a proprietary device (the "NOxMaster™") shown to reduce the pollutant content of automobile emissions. The cost of acquiring this patent was capitalized under the caption "Patent license" on the balance sheet. After the acquisition of this patent, the Company has continued to refine the device and expand its applicability to a wider range of vehicles. Also, the Company has been performing tests aimed at obtaining California and EPA certifications to be able to advertise and sell the device as a pollution reduction system. The Company obtained a ruling by the California Air Resource Board in 2001 that the diesel device does not increase pollutants. Obtaining the ruling and certification greatly expands the markets for the device. The Company's rights to the patent are subject to royalties totaling 7% of wholesale sales. The royalties do not require the Company to make minimum payments. Management has estimated that additional costs required to obtain governmental certifications should be in the \$250,000 to \$400,000 range.

During 2002, the Company acquired Carbon Cloth Technologies, Inc. in order to obtain rights to its CarbonGuard™ technology. This product is currently being marketed and the Company expects to be able to increase the product's market penetration. The CarbonGuard™ is a product that provides innovative insulation capabilities for stationary and high-performance engines.

Besides the tests toward certification in California, the products have been tested in England for their application to pollution control on diesel taxicabs and buses. This testing is being carried on by KSL, an entity in which the Company owns an indirect equity interest as discussed elsewhere.

The Company has continued to obtain additional patents that extend and protect its primary patent. A device for emission control on small engines has also been patented. Legal costs to file these patents are being capitalized.

During 1996, the Company entered into an agreement to grant the Company's president an exclusive license for the worldwide rights to manufacture, market, distribute, and sell the NOxMaster™'s application to diesel engines. In addition, the agreement granted the same rights for the application of the NOxMaster™' to gasoline engines in Europe, the former Soviet Union, the Middle East, and Africa. In exchange for this transfer, the Company's president has established, KleenAir Systems International, Inc. (KASI), in the United Kingdom and transferred this license to it. KleenAir Systems, Ltd. of the U.K. is a wholly owned subsidiary of KASI. The Company received a 30% ownership interest in KASI and is to receive a royalty of 8% of its gross revenue from sales of the product.

During 1998, the Company repurchased the rights to the diesel system in the U.S. market by issuing 1,000,000 shares of common stock to Pollution Control, Inc., an entity controlled by the Company's president. This action was taken based on the advice of financial consultants to the Company.

The Company and KASI also entered into a license agreement with Extengine Transport Systems, LLC (ETS) which is in the business of commercialization of environmental technologies and products. This license is for a ten-year, nonexclusive, worldwide manufacturing, marketing, and selling license for NOxMaster™ devices. The Company has also entered into an exclusive ten-year California manufacturing, marketing rights, and distribution rights agreement for application of the NOxMaster™ to gasoline engines and a ten-year, exclusive manufacturing, marketing, and distribution rights agreement for application of the NOxMaster™ devices in China and India and to school and urban buses. These licenses set out per-unit prices and specify minimum annual units for each application once the Company has produced a commercially viable device and demonstrates manufacturing capability. During 2002, the Company moved to eliminate Extengine's exclusivity in certain markets. This action was undertaken because of certain actions and certain inactions on the part of Extengine. During 2003, Management negotiated a settlement with ETS for its release of the exclusivity portions of its agreements. This allows the Company to pursue sales of the products in these markets.

#### **NOTE 9: PROPERTY AND EQUIPMENT**

The following table presents costs of property and equipment at December 31, 2003 and 2002.

	<u>2003</u>	<u>2002</u>
Office furniture and equipment	\$ 61,497	\$ 61,497
Test vehicles	28,928	28,028
Analysis equipment	167,139	158,358
Leasehold improvements	<u>11,682</u>	<u>11,682</u>
Totals	269,246	259,565
Accumulated depreciation	<u>(113,635)</u>	<u>(63,945)</u>
Net Property and Equipment	<u>\$ 155,611</u>	<u>\$ 195,620</u>

Depreciation expense totaled \$49,690 and \$33,579 for 2003 and 2002. The office furniture and equipment, the analysis equipment, and the test vehicles are being depreciated on a straight-line basis over five years. Leasehold improvements are being depreciated on a straight-line basis over 39 years.

#### **NOTE 10: COMPENSATORY STOCK BENEFIT PLANS AND VALUATION BASIS**

During 1995, the Company adopted a Compensatory Stock Benefit Plan (the 1995 Plan) for the furtherance of the Company by allowing the Company the option of compensating officers, directors, consultants, and certain other service providers who render bona fide services to the Company through the award of the Company's free trading common shares. Under the Plan, 33,333 shares were approved by the Board of Directors. Of the shares approved for the Plan, 13,000 shares were issued, 4,667 were committed in agreements with officers, and 2,667 were committed to a consultant during 1995. During 1996, 9,667 shares were issued under this plan for directors' fees and officer compensation. These shares have been issued primarily for marketing and promotion services, directors' fees, and facilitation of the purchase of the patent.

The 1995 Plan was terminated with the adoption of a "1996 Consultant and Employee Stock Compensation Plan" (the 1996 Plan). The 1996 Plan authorized the issuance of up to 500,000 freely tradable shares. These shares were to be used to further the growth through compensation of officers, directors, consultants, and other service providers. The board was given the authority to increase the number of shares as it deemed advisable and to file any necessary registration statements required for such increases. Under the 1996 Plan, the Company issued 5,333 during 1996, but did not issue any shares under this plan in 1997 or 1998. During 1999, the Company issued 300,000 shares under this plan for consulting services.

In July 2000, the Company filed an S-8 registration to register 1,200,000 shares for the compensation under five consulting agreements and reserved 750,000 shares for the future exercise of options under an Employee Stock Option Plan, discussed below. The shares for the consultants were issued in July in order to obtain those services. Subsequent to this filing, the board has issued 550,000 of the shares reserved for the ESOP. Directors/officers and a key engineering consultant were issued 300,000 of these shares for unpaid services and a consultant who had previously been issued 250,000 restricted shares for his services requested that he be allowed to exchange those shares for S-8 shares and was allowed to do so under advice of legal counsel. During 2002, the Company issued an additional 76,800 shares under this plan.

In September 2001, the Company filed an amendment to its S-8 to register an additional 2,200,000 shares. Of these shares, 1,270,000 were issued in October to consultants for services to be provided over the next year. Another 21,687 of these shares were issued to product development consultants. During 2002, the Company issued (or contracted to issue) 576,192 shares to consultants and employees.

In September 2003, the Company filed an additional amendment to its S-8 to register another 1,250,000 shares. All of these shares were issued to consultants for services provided during the last quarter of the year.

As anticipated by these plans, the Company has acquired services with free trading shares. The Company has also issued restricted (Rule 144) stock in exchange for services. Transactions utilizing free trading stock have been valued at the trading price for market shares on the date of the transaction. Transactions utilizing restricted stock have been valued at one-half of the trading price on the date of the transaction.

#### **NOTE 11: EMPLOYEE STOCK OPTION PLAN**

The Employee Stock Option Plan (ESOP) was established in July 2000 in coincidence with the S-8 registration and is to provide incentives for the attraction and retention of personnel. Its terms call for an exercise price of 100% of the closing price of the Company's stock on the date of the grant of the options. No such grants have been made under this plan.

#### **NOTE 12: STOCKHOLDERS' EQUITY**

During 1986, the Company completed an initial offering of 10,000,000 shares of common stock with net proceeds (after commissions) of \$110,233. Between that time and December 31, 1993, it is apparent that there were several stock transactions, reverse splits, and other actions. However, records regarding this period of time are not available. Additionally, no records are available which would allow an analysis of the retained earnings balance prior to 1994. Due to this lack of records, management believes that losses indicated by the negative retained earnings would not yield tax benefits to current operations. Inception-to-date information required for development stage companies is also unavailable for this period.

In March 1995, the Company's Board approved a measure (ratified at a subsequent shareholders' meeting) whereby the Company's outstanding common shares were reverse split on the basis of one new share for ten shares held. In May 1997, the Board approved another reverse split. This time the reverse split was on the basis of one new share for 15 shares held. In the following discussion, the share amounts have been restated to reflect the 1 for 15 reverse split. In February 2000, the Board approved a 2 for 1 split of shares effective March 20, 2000 in accordance with current marketing and investment advice. All share amounts in the financial statements as well as share amounts presented below have been presented as though all of these changes in stock had occurred prior to the earliest presented information.

In April 1995, the Company issued 933,334 shares of convertible, non-voting preferred stock and 60,000 common shares as consideration for the patent and a facilitation fee to a consultant. This transaction was recorded at the par value of the stock issued, \$7,400.

During 1995, other consulting services not directly related to the patent purchase were obtained through the issuance of 24,000 common shares valued at total of \$111,875. Directors were issued a total of 4,000 shares valued at \$22,500. This stock-based compensation, as well as the transactions described below, has been valued as described in Note 9. The Company also issued 27,334 common shares pursuant to a Regulation S offering. Net proceeds to the Company after commissions were \$66,804. In addition, \$180,400 was received for 66,814 shares under the Regulation S offering prior to December 31, 1995, with the shares being issued during 1996.

During 1996, the Company issued 24,666 common shares and 13,334 preferred shares primarily to officers and directors pursuant to agreements and directors' resolutions for services rendered. These shares were valued at \$201,875. Holders of options also exercised 75,000 options to acquire a like number of common shares during March 1996 by trading amounts owed them by the Company for the exercise price. This action effectively brought \$112,500 to the Company through the reduction in payables.

During 1997, the Company issued 66,666 preferred shares to its president in accordance with his employment contract. During December 1998, the Board approved the issuance of 320,000 shares of stock to themselves and key consultants as compensation for services rendered during 1998. Both of these sets of shares have been included as outstanding shares and the costs have been recognized as expenses in the relevant periods. The shares were issued during 1999.

During 1998, preferred stockholders exchanged 403,330 shares for a like number of common shares. The Company issued 2,000,000 shares to a financial and public relations consultant for services; 2,000,000 and 800,000 shares to Pollution Control, Inc. for license and cash as discussed at Note 13; and 100,000 shares to a development consultant. A director was issued 20,000 shares for his services.

During March 1999, the Company issued 600,000 shares under its S-8 plan discussed at Note 9 for investment guidance. These shares were valued at \$75,000. Public relations/financial services were obtained during 1999 through the issuance of 508,334 shares valued at \$175,079. Analysis and test equipment was acquired in exchange for 33,200 shares valued at \$8,300. The Company also issued 146,800 shares for \$35,800 cash and exchanged 61,334 common shares for the retirement of a like number of preferred shares.

During 2000, the Company issued 1,400,000 shares to Ecologic, LLC (an affiliate of Extengine, Inc.) for \$350,000 under an agreement to provide funds for product testing. The Company issued 300,000 shares valued at \$51,000 to officers and directors and key engineering consultant in lieu of cash payments for their services to the Company. Outside consulting services were obtained in exchange for 1,344,266 shares valued at \$553,868. (See discussion at Note 9 regarding 1,200,000 of these shares.) The Company also retired the last of its outstanding preferred shares through their conversion to 163,334 common shares. One of the issuance of shares for services included warrants (discussed below). The holders exercised a 14,000 of these warrants for proceeds of \$8,750.

As discussed in Note 13, the Company also issued both common and preferred stock for consulting services and employment agreements.

The Company issued options to purchase common shares during 1996. These options arose from various transactions. Among these were 210,000 options granted as incentives for enhanced product development efforts. Other options were granted as incentives to sign service contracts. All options issued were to purchase one share for each option held. There was no market for these options. During 1996, options were exercised to purchase 75,000 shares. Options were reduced by the 1 for 15 reverse split authorized by the board of directors. No options were exercised during 1997 or 1998 and at December 31, 1998, all options had expired.

As mentioned above, during 2000, the Company issued warrants in conjunction with a stock issuance. These consisted of 138,000 warrants to buy one restricted share at \$0.625 per warrant and expired on November 30, 2001. Of these, 14,000 were exercised during 2000 and the rest expired. The Company also issued two warrants to Ecologic. The first warrant which expired January 31, 2001, was for the purchase of 1,000,000 shares at \$.25 per share. Ecologic purchased 900,000 shares under this warrant during 2000, leaving a balance of 100,000 that were allowed to expire. The second warrant, which expired January 31, 2002, was to purchase 1,000,000 shares at the greater of \$1 or one-half the average thirty-day bid price per share. This warrant expired without exercise.

During 2001, the Company issued 218,500 restricted shares valued at \$120,436 to consultants. Another 850,000 restricted shares valued at \$78,540 were issued to directors and a key research person for services over the last year. Cash of \$105,000 was received for the issuance of 375,000 restricted shares. Consultants were issued 1,368,487 unrestricted S-8 shares valued at \$180,650.

During 2002, the Company issued the following restricted shares: 15,500 valued at \$3,500 for product development, 50,000 valued at \$16,250 for legal services, 100,000 valued at \$32,500 for contract settlement, 500,000 valued at \$87,500 for uncompleted acquisition, and 833,250 valued at \$924,908 for Carbon Cloth acquisition. Another 2,804,545 restricted shares were issued for cash totaling \$1,720,000. In addition to restricted shares, the Company issued free-trading shares as follows: 524,192 valued at \$257,342 for consulting services, 40,000 valued at \$44,400 for Carbon Cloth acquisition, and 12,000 valued at \$8,340 for product development.

During 2003, the Company issued the following restricted shares as follows: 750,000 for cash totaling \$75,000, 215,000 valued at \$46,850 for consulting services, 50,000 valued at \$8,250 for legal services, 7,600,000 valued at \$519,090 to directors and a key research person for services, and 82,500 valued at \$12,788 for settlement of claims relating to marketing licenses. The Company also issued unrestricted shares as follows: 2,100,673 valued at \$317,003 for consulting services, 22,500 valued at \$4,534 for product development efforts, 50,000 valued at \$11,625 for settlement of claims related to marketing licenses, 228,932 valued at \$55,053 for legal and other professional services, and 52,000 valued at \$7,537 for office and clerical services.

#### **NOTE 13: EARNINGS PER SHARE**

Basic earnings per share has been calculated based on the weighted average common shares outstanding. A warrant to purchase 240,000 shares and an option to purchase 200,000 shares at \$0.625 per share were outstanding at December 31, 2002. Both of these were to expire in 2004. The option for 200,000 shares was canceled during 2003, leaving a balance of 240,000 options outstanding at December 31, 2003. The shares underlying these options have not been added to outstanding common shares in a presentation of diluted earnings per share because the presentation would prove anti-dilutive.

#### **NOTE 14: RELATED PARTY TRANSACTIONS**

Many of the Company's consultants have, historically, also been stockholders of the Company. This includes engineering services, marketing and financial promotion, and management and stockholder services. As mentioned above, upon the purchase of the patent, the previous owners became preferred stockholders. Individuals involved with the previous owner continued many of the development and other services that they were previously providing.

See also the discussion of the granting of a license for Europe to the Company's President at Note 8 and the discussion at Note 15 regarding the aborted acquisition of National Diversified Telecom, Inc.

During 1998, the Company sold 800,000 shares of common stock to Pollution Control, Inc. for \$200,000. These funds were used to prepay financial and public relations services. The service provider also received 2,000,000 shares of restricted common stock that it assigned to Pollution Control in exchange for an equity interest in that entity. As discussed at Note 8, the Company issued 2,000,000 shares of restricted common stock to Pollution Control to repurchase the U.S. marketing rights for its diesel product. Pollution Control is controlled indirectly by the Company's President. Pollution Control's voting rights are held by the Company's President. These transactions effectively transferred control of the Company to Pollution Control and the Company's President through his control of that block of voting stock.

During July 1999, the Board approved the issuance of 420,000 shares of restricted stock to themselves and an engineering consultant for loans provided to the Company during 1999. In October 1999, the Board approved the issuance of 1,000,000 shares to themselves and the consultant in lieu of cash compensation in recognition of services provided to the Company during 1999.

In December 2000, the Board approved the issuance of 300,000 free-trading S-8 shares to themselves and an engineering consultant in lieu of cash payment for services rendered to the Company during 2000.

In July 2001, the Board approved the issuance of 850,000 restricted shares to themselves and an engineering consultant in lieu of cash payment for services rendered to the Company during 2001. Additionally, the Board approved allowing the Board to purchase restricted shares to obtain cash. One member of the Board and an entity related to a member of the Board paid \$85,000 for 325,000 shares.

During December 2002, members of the Board purchased 350,000 shares of restricted stock for \$70,000. Additionally, Pollution Control, Inc. lent the Company \$50,000 documented in a demand note.

During 2003, the Board approved the issuance of 7,600,000 restricted shares to themselves and an engineering consultant as compensation for their services in lieu of cash payments. Loans from related parties totaled \$147,000 during 2003. These loans were documented in demand notes and bear interest at the rate of 7% with interest compounded monthly if not paid.

In 2003, the Company generated a significant portion (\$202,544) of its revenues from sales of its NOxMaster™ product to KASI (discussed at Note 3) which, in turn, sold them to KSL. KSL sold the products to a third party for installation on U.K. taxicabs and buses. The Company recognized its revenues at the first level, i.e., sales to KASI. At this point, there has been no inclusion of KASI in the Company's financials due to cumulative losses incurred by that entity. No eliminations have taken place. This sales structure exists because of licensing arrangements discussed at Note 8.

#### **NOTE 15: EXTRAORDINARY LOSS ITEMS**

During February 1996, the Company entered into an agreement to acquire 100% of the stock of National Diversified Telecom, Inc. (NDT). The Company's president was also a significant owner of NDT. The acquisition required the issuance of 40,000 shares of the Company's restricted common stock. In addition, the Company advanced \$15,000 to NDT for operations. It was subsequently determined that the Company would not benefit from the attributes of NDT that the Company had anticipated. As a result of this determination, the Company defaulted on its agreement to provide an additional \$5,000 to NDT and moved to "undo" the agreement. In "undoing" the agreement, the Company did not receive back the \$15,000 or the stock. The value of the shares, the \$15,000, NDT audit fees paid by the Company and certain other costs have been reported as an extraordinary item in the Statement of Operations.



In 2002, the Company initiated an acquisition agreement. By the terms of the agreement, the Company issued 500,000 restricted shares to the owner of the target as a discussion incentive. Additional shares and cash were due on consummation. This deal has placed on hold for at least the time being. The shares, valued at \$87,500, have been recorded as an extraordinary expense.

#### **NOTE 16: ACQUISITION OF CARBON CLOTH TECHNOLOGIES, INC.**

Effective April 30, 2002, the Company acquired Carbon Cloth Technologies, Inc. (Carbon Cloth), a California corporation. Carbon Cloth is a manufacturer of automotive thermal management systems. Its CarbonGuard™ product is currently installed on a number of New York City Transit Authority buses as enhancements for the operating efficiency of particulate traps. This product generated revenues during 2003 and is expected to generate additional revenues in the future. Its primary market at this time is environmentally mandated retrofit applications which are largely funded by governmental agencies. These agencies operate under strict annual budgets which limit the size of any given project and cause deferral of work from year to year. As the product continues to prove its viability, sales are expected to grow. It is also anticipated that there will be a synergy of sales from the combination of the Company's emission control device and Carbon Cloth's products.

This acquisition was accomplished through the issuance of common stock in exchange for all of the stock of Carbon Cloth. The results of operations of Carbon Cloth have been included in the Company's consolidated financial statements since the date of acquisition. The Company issued 833,250 restricted shares for this acquisition along with 40,000 unrestricted S-8 shares issued for services provided in the acquisition process. A portion of the acquisition agreement created an employment agreement that called for the issuance of an additional 146,750 shares as incentive commissions based on achievement of product sales. These additional shares were compensation and were contingent upon the achievement of certain sales levels.

The purchase price was allocated to the individual assets acquired (primarily the CarbonGuard™ product) and liabilities assumed based upon their respective fair values at the date of acquisition as set forth below. Accounting rules require the recognition of deferred taxes for difference between the tax bases of the assets acquired and the amounts recorded in the consolidated books. The acquisition resulted in the addition of the following balance sheet elements as of April 30, 2002:

Accounts receivable	\$ 22,397
Inventory	10,331
Fixed assets (net)	1,392
Patent license	1,474,003
Payables	(96,144)
Deferred tax liability	(397,853)
Equity	(1,014,126)

#### **NOTE 17: LEASE**

During May 2002, the Company leased a facility containing office space and space for continuing product development and testing. This facility combined the Company's offices and testing at the same facility. The lease is a three-year noncancellable lease. The Company was required to deposit \$46,200 (the last six months lease payments) with the landlord as security for the lease. The monthly lease is \$7,700. Future minimum payments under this noncancellable lease totals \$123,200 at December 31, 2003. This amount includes the deposit which will represent a prepayment of the final six months rental.

#### **NOTE 18: CONCENTRATIONS**

As mentioned in other places above, a majority of the Company's NOxMaster™ sales have been for installation in England. In addition, the Company sold \$287,200 worth of particulate traps directly to Dinex, the entity purchasing and installing the NOxMaster™ equipment in the U.K. Sales of the CarbonGuard™ were also concentrated with \$187,435 being sales to Johnson Mather, Inc. These concentrations are expected to continue for at least the near future until such time as the Company can obtain certifications from the CARB and EPA.

**NOTE 19: SUBSEQUENT EVENTS**

During the first quarter of 2004, the Company has sold 250,000 restricted shares for \$25,000 and entered into an option for this purchaser to acquire an additional 500,000 shares in April 2004. It has also entered into consulting contracts requiring the issuance of 460,000 unrestricted shares.

In March 2004, the Company entered into a transaction whereby it exchanged 10,026,666 restricted shares for 910,569 shares of Jubilee Investment Trust, PLC. Jubilee is a British entity listed on the London Stock Exchange.

The Company announced an agreement with Beijing Luchuang Environmental Protection Group in China to evaluate the Company's technologies with regard to utilization and manufacturing in China. Tests of these technologies is currently being conducted at two university testing facilities in Beijing. The Company also announced that the Energy Savings Trust in the U.K. has restructured their emission control funding grants to include a new category for a 75% cost subsidy. This new category currently contains only KleenAir's products. The funding grants are government's cost subsidy program for its emission control retrofit programs.

EXHIBIT 23.1 Consent of Robert Early & Company, P.C.

CONSENT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANT

We hereby consent to the incorporation by reference into the Form S-8 Registration Statement No. 333-105591 regarding the Stock Compensation Plan of KleenAir Systems, Inc. of our report dated March 22, 2004 which is being included in the annual report on Form 10-KSB of KleenAir Systems, Inc. for the year ended December 31, 2003.

/s/ ROBERT EARLY & COMPANY, P.C.  
Robert Early & Company, P.C.

Abilene, Texas  
April 13, 2004

EXHIBIT 31 - Certification of Chief Financial Officer and Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

CERTIFICATION

I, Lionel Simons, certify that:

1. I have reviewed this annual report on Form 10-KSB of KleenAir Systems, Inc.;
2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;
4. I am responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:
  - a) Designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to me by others within those entities, particularly during the period in which this annual report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and
  - c) Presented in this annual report my conclusions about the effectiveness of the disclosure controls and procedures based on my evaluation as of the Evaluation Date;
5. I have disclosed, based on my most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) All significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of my most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: April 14, 2004

/s/ Lionel Simons  
Lionel Simons, Chief Executive  
Officer and Chief Financial Officer

EXHIBIT 32.1 -- Certification of Chief Operating Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

CERTIFICATION PURSUANT TO SECTION 906  
OF THE SARBANES-OXLEY ACT OF 2002

In connection with the filing of KleenAir Systems, Inc. (the "Company"), on Form 10-KSB for the period ended December 31, 2003, as filed with the Securities and Exchange Commission (the "Report"), the undersigned, Lionel Simons, President and Chief Executive Officer of the Company, hereby certifies pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C.ss.1350), that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: April 14, 2004

/s/ Lionel Simons  
Lionel Simons, President and  
Chief Executive Officer

EXHIBIT 32.2 -- Certification of Chief Financial Officer pursuant to Section 906 of Sarbanes-Oxley Act.

CERTIFICATION PURSUANT TO SECTION 906  
OF THE SARBANES-OXLEY ACT OF 2002

In connection with the filing of KleenAir Systems, Inc.(the "Company"), on Form 10-KSB for the period ended December 31, 2003, as filed with the Securities and Exchange Commission (the "Report"), the undersigned, Lionel Simons, the Chief Financial Officer of the Company, hereby certifies, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C.ss.1350), that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: April 14, 2004

/s/ Lionel Simons  
Lionel Simons, Chief Financial Officer